

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of :
Mandy of Quality, Inc. : AFFIDAVIT OF MAILING
for Redetermination of a Deficiency or Revision :
of a Determination or Refund of Corporation :
Franchise Tax under Article 9A of the Tax Law for :
the Years 1975 - 1977. :

State of New York }
County of Albany } ss.:

David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 15th day of June, 1984, he served the within notice of Decision by certified mail upon Mandy of Quality, Inc., the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Mandy of Quality, Inc.
126-20 101st Ave.
Richmond Hill, NY 11419

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the petitioner herein and that the address set forth on said wrapper is the last known address of the petitioner.

Sworn to before me this
15th day of June, 1984.

David Parchuck

James A. Haggard
Authorized to administer oaths
pursuant to Tax Law section 174

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of :
Mandy of Quality, Inc. : AFFIDAVIT OF MAILING
for Redetermination of a Deficiency or Revision :
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Franchise Tax under Article 9A of the Tax Law for :
the Years 1975 - 1977. :

State of New York }
County of Albany } ss.:

David Parchuck, being duly sworn, deposes and says that he is an employee of the State Tax Commission, that he is over 18 years of age, and that on the 15th day of June, 1984, he served the within notice of Decision by certified mail upon Daniel J. Guida, the representative of the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

Daniel J. Guida
Fliegel & Guida
231 Vermont Ave.
Oceanside, NY 11572

and by depositing same enclosed in a postpaid properly addressed wrapper in a post office under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the representative of the petitioner herein and that the address set forth on said wrapper is the last known address of the representative of the petitioner.

Sworn to before me this
15th day of June, 1984.

David Parchuck

James A. Heyland
Authorized to administer oaths
pursuant to Tax Law section 174

STATE OF NEW YORK
STATE TAX COMMISSION
ALBANY, NEW YORK 12227

June 15, 1984

Mandy of Quality, Inc.
126-20 101st Ave.
Richmond Hill, NY 11419

Gentlemen:

Please take notice of the Decision of the State Tax Commission enclosed herewith.

You have now exhausted your right of review at the administrative level. Pursuant to section(s) 1090 of the Tax Law, a proceeding in court to review an adverse decision by the State Tax Commission may be instituted only under Article 78 of the Civil Practice Law and Rules, and must be commenced in the Supreme Court of the State of New York, Albany County, within 4 months from the date of this notice.

Inquiries concerning the computation of tax due or refund allowed in accordance with this decision may be addressed to:

NYS Dept. Taxation and Finance
Law Bureau - Litigation Unit
Building #9, State Campus
Albany, New York 12227
Phone # (518) 457-2070

Very truly yours,

STATE TAX COMMISSION

cc: Petitioner's Representative
Daniel J. Guida
Fliegel & Guida
231 Vermont Ave.
Oceanside, NY 11572
Taxing Bureau's Representative

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition	:	
of	:	
MANDY OF QUALITY, INC.	:	DECISION
for Redetermination of a Deficiency or for	:	
Refund of Corporation Franchise Tax under	:	
Article 9-A of the Tax Law for the Years 1975	:	
through 1977.	:	

Petitioner, Mandy of Quality, Inc., 126-20 101st Avenue, Richmond Hill, New York 11419 filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 1975 through 1977 (File No. 31310).

A formal hearing was held before Daniel J. Ranalli, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on June 23, 1983 at 1:15 P.M., with all briefs to be submitted by September 15, 1983. Petitioner appeared by Fliegel & Guida (Daniel J. Guida, C.P.A.). The Audit Division appeared by John P. Dugan, Esq. (Anna D. Colello, Esq., of counsel).

ISSUES

I. Whether the Audit Division properly disallowed a salary expense of petitioner and correctly added said expense to the income of petitioner's president as a constructive dividend.

II. Whether the Audit Division properly determined that a loan made to petitioner by its president was, in fact, a contribution to capital and, therefore, a reduction in petitioner's loan account amounted to a constructive dividend or return on capital to petitioner's president.

FINDINGS OF FACT

1. On September 12, 1980, as the result of a field audit, the Audit Division issued a Notice of Deficiency pursuant to Article 9-A of the Tax Law against petitioner, Mandy of Quality, Inc., in the amount of \$257.26 plus interest of \$98.40 for a total due of \$355.66 for the year ended December 31, 1975. On the same date another Notice of Deficiency was issued against petitioner in the amount of \$269.56 plus interest of \$80.19 for a total due of \$349.75 for the year ended December 31, 1976. A third Notice of Deficiency was issued on the same date against petitioner in the amount of \$2,759.30 plus interest of \$586.35 for a total due of \$3,345.65 for the year ended December 31, 1977.

2. Petitioner is a New York corporation engaged in the operation of a home improvement contracting business. The sole officer, and, apparently, sole stockholder of petitioner is Aaron Mandelbaum, its president. The business originally was a sole proprietorship which was incorporated on or about January 1, 1973. At the time of incorporation, petitioner carried over onto its corporate books an account entitled "Officer's Loans Payable" in the amount of \$109,989.95. There was no owner's equity account and no stock was issued upon incorporation. Petitioner's assets totalled \$311,433.36 and its liabilities amounted to \$311,144.36 leaving an owner's equity of \$289.00 resulting in a debt to equity ratio of approximately 1000 to 1. Payments were made from the officer's loans payable account either directly to Aaron Mandelbaum or to pay Mr. Mandelbaum's personal expenses. Petitioner did not carry a capital account on its books until 1975 when \$10,000.00 in stock was issued. In 1974, petitioner obtained a loan from Bankers Trust Company which required as a condition of the loan that petitioner's loans due its officer be subordinated to the bank's loan. Petitioner complied with this requirement.

3. On audit, the auditor decided that petitioner was under-capitalized and that the approximately \$110,000.00 in loans made by Aaron Mandelbaum to petitioner were actually contributions to capital. For 1977, petitioner's general ledger reflected a reduction in the loan account of \$16,241.74 and this figure, taken together with an unexplained difference of \$19,274.12, resulted in a total reduction in the loan account of \$35,515.86 which was deemed to be a constructive dividend or return on capital. Tax year 1977 was the only year in which petitioner's income was sufficient to establish a constructive dividend or return on capital. Aaron Mandelbaum's personal income tax for 1977 was adjusted to include in his income for that year the loan repayments deemed to be constructive dividends.

4. Petitioner maintains that the loans from Aaron Mandelbaum were bona fide loans which were never intended to be capital contributions and that the Audit Division should not be able to deem the loans to be such merely because petitioner did not issue any stock until two years after its formation. However, at least one of the loans in the amount of \$66,529.90 was evidenced by a written promissory note dated February 5, 1974. No explanation was offered as to why said note was issued more than a year after petitioner was incorporated. Petitioner's representative asserted that this was the amount remaining to be paid on the original loan on the books on January 1, 1973.

5. For years 1976 and 1977, petitioner claimed a salary expense for Rosalie Mandelbaum, the wife of Aaron Mandelbaum. Petitioner issued wage and tax statements (Form W-2) to Mrs. Mandelbaum for each of the aforesaid years. The forms indicated that Federal and State taxes and social security taxes were withheld.

6. On audit, the auditor went to petitioner's premises on four different occasions. Mrs. Mandelbaum was not present at the place of business during any of these visits. The auditor questioned several of petitioner's employees concerning the status of Mrs. Mandelbaum as an employee. The employees' responses were either evasive, vague or conflicting, with none of the employees actually sure of what Mrs. Mandelbaum's duties were, if any. Petitioner submitted several unsworn, form statements from contractors indicating that Mrs. Mandelbaum solicited various leads for them as part of her duties for petitioner. Other than the statements, petitioner presented no direct evidence either through testimony or documentation to show whether Rosalie Mandelbaum performed any duties as an employee of petitioner.¹ Mrs. Mandelbaum was not an officer or stockholder of petitioner.

7. The Audit Division disallowed the salary expense with respect to Mrs. Mandelbaum and deemed it to be a constructive dividend to Mr. Mandelbaum. Mr. and Mrs. Mandelbaum's personal income taxes were adjusted accordingly for each of the years 1976 and 1977. Petitioner argues that it had nothing to gain by claiming Mrs. Mandelbaum as an employee since it incurred other expenses such as social security and unemployment compensation payments by listing Rosalie Mandelbaum as an employee.

CONCLUSIONS OF LAW

A. That, with certain exceptions not applicable herein, section 1089(e) of the Tax Law places the burden of proof upon the petitioner. Although petitioner may well have had nothing to gain by claiming Rosalie Mandelbaum as an employee, there was simply too little evidence produced to substantiate that she was an employee. Petitioner has not shown that Mrs. Mandelbaum performed

¹ In fact, petitioner offered no testimony on either issue.

any substantial services which were of value to the corporation. In light of this and the fact that Mr. Mandelbaum was the sole stockholder of petitioner, it was proper for the Audit Division to consider the payments to Mrs. Mandelbaum an assignment of corporate income not deductible by petitioner and taxable to Mr. Mandelbaum as a constructive dividend.

B. That "[a] corporation's financial structure in which a wholly inadequate part of the investment is attributed to stock while the bulk is represented by bonds or other evidence of indebtedness to stockholders is lacking in the substance necessary for recognition for tax purposes, and must be interpreted in accordance with realities" (Root v. Commissioner, 220 F.2d 240, 241). "The essential difference between a stockholder and a creditor is that the stockholder's intention is to embark upon the corporate adventure, taking the risks of loss attendant upon it so that he may enjoy the chances of profit. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided, but merely to lend his capital to others who do intend to take them" (United States v. Title Guarantee & Trust Co., 133 F.2d 990, 993).

C. That among the factors which are significant in deciding whether an instrument or transaction creates debt or equity are: "thin" or inadequate capitalization, identity of interest between creditor and stockholder, the ability of the corporation to obtain loans from outside lending institutions and the status of the contribution in relation to regular corporate creditors (Slappey Drive Industrial Park v. United States, 561 F.2d 572, 582).

D. That, with an owner's equity of \$289.00, a debt-equity ratio of 1000 to 1, the lack of any capital account or issuance of any stock, it is obvious that the funds supplied by Aaron Mandelbaum to petitioner did not constitute a loan to a company with adequately existing operating capital, but represented, instead, an advance of necessary working capital. "Such a situation closely

parallels that under which an investment of equity capital is made in a new venture..." (Hippodrome Building Co. v. Commissioner, 24 TCM 113 aff'd sub nom Fellinger v. United States, 363 F.2d 826). Moreover, Banker's Trust Co. would not agree to loan money to petitioner unless all loans due to officers were completely subordinated to the bank's loan. "The complete subordination effected by [this agreement] not only tends to wipe out a most significant characteristic of the creditor-debtor relationship, the right to share with general creditors in the assets in the event of dissolution or liquidation, (citation omitted), but it also destroys another basic attribute of creditor status: i.e., the power to demand payment at a fixed maturity date" (P.M. Finance Corp. v. Commissioner, 302 F.2d 786, 790).

E. That, while no one of the aforementioned debt-equity factors necessarily indicates the existence of a capital contribution rather than a loan, in this case, all of the facts taken as a whole and combined with the fact that the alleged lender in this case, Aaron Mandelbaum, was also the sole stockholder and officer of petitioner leads to the conclusion that the \$109,989.95 entered on petitioner's books as officer's loans payable was, in fact, an investment in the equity of petitioner and subject to tax treatment as such. Therefore, the Audit Division properly deemed the reduction in the loan account to be a constructive dividend or return on capital to Aaron Mandelbaum.

F. That the petition of Mandy of Quality, Inc. is denied and the notices of deficiency issued September 12, 1980 are sustained.

DATED: Albany, New York

JUN 15 1984

STATE TAX COMMISSION

Radwan A. Clem
PRESIDENT
Francis P. Koenig
COMMISSIONER
Mark J. Dink
COMMISSIONER